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BY AARON RUBIN, JD, CPA, CFP

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Top Risks to Retirement Income: *Part 2*

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Part 1 of exploring the dangers to retirement cash flow discussed the three greatest threats to a retiree's financial plan: inflation, over withdrawal, and underinsurance. Retirees also struggle with how to invest, and systemically withdraw, their retirement savings. Part 2 focuses on investment concepts that advisors to retirees and individual investors should be familiar with—market exposure, high yield investments, and illiquidity. To set the stage, it's helpful to understand these key terms:

- **Market exposure** means the portion of an investor's portfolio that is invested in the stock market (both international and US).

- **High-yield investments** are either equities (stocks) or bonds that generate more cash flow than the average market security for the investor. In contrast, low-yield investments like short-term treasury notes tend to have lower cash flow than the average market security.
- **Illiquidity** means the lack of ability to turn an investment back into cash either because of restrictions or penalties. It relates to cash flow, which is producing a stream of income for the investor.
- **Sequence of returns:** this means that the market does not move linearly, and throughout the portfolio's investment period it's possible that losses can occur at any time.

1. The Risk of Overexposure to the Market for Retirees

Equity (stock) markets are a dangerous place to be for investors. While we all tout the benefits of being in the market, we tend not to focus so much on the downsides (Dimensional Fund Advisors [DFA], 2021). For example, from 1926 to the end of 2021, 68% of the time the US large stock market return swung between +28.95% and 8.39% (DFA, 2021). This means we can infer that 32% of the time, the returns swung in even more extreme ways up and down. Portfolios that include small-cap, value, and international stocks face even more market turbulence. This is because small-cap companies represent the smallest part of the market. These are the companies that are most likely to go out of business in a market downturn. Similarly, value companies are those who may be undervalued due to a variety of factors such as management issues, or industry sector concerns. International companies are those that are based in countries outside of the US. Aside from market risk, US investors also face currency risk. The unpredictable nature of the stock markets leads to a sequence of returns (defined above) issue.

This means that financial advisors can be correct about the average rate of return in a particular client's portfolio over a long period of time, but a portfolio can still fail to achieve a desired rate of return in the timeframe the client needs, despite the financial advisor having made appropriate assumptions about the client's risk tolerance, time horizon, and available investable assets. The real buzzsaw happens when retirees are taking distributions, often required minimum distributions, from their retirement portfolio and the portfolio has low investment returns early on in retirement (Berger, 2021). This can ruin the long-term value of a retirement portfolio.

For example, imagine a retiree with $2 million who needs to withdraw $100,000—around 5% of the initial investment—from their all-equity (stock) portfolio. If the person chose to invest in the S&P 500 in 2000, taking dividend distributions at the end of each year, by the end of 2001, they would have around $1.4 million, making their new withdrawal rate over 7%, instead of 5%. This is the result of a poor sequence of returns. Since the bigger negative years happened early on, it had a disproportionate impact on the withdrawal rate of the portfolio.

In Part 1, we discussed withdrawal rates from retirement portfolios. William Bengen called withdrawals over 6% "gambling." So, in our example above, we took a reasonable rate of withdrawal of 5% and turned it into a gambling portfolio of 7%. What's more, since the investor had to sell shares of stock to have enough cash to withdraw $100,000, their portfolio will not be able to recover effectively in the following years.

Managing the Risk of Overexposure

To combat this problem, an investor should take less risk in a retirement portfolio that has required or needed distributions, particularly when the investor relies heavily on the distributions for their basic living needs. Advisors should counsel their clients to consider a healthy amount of fixed income in any distribution portfolio. How much fixed income depends on how fast the investor draws down the principal in the retirement portfolio and the investor's comfort with their financial reserves. In our example above, should the $2 million client want to make sure they have three years of fixed income in case of a prolonged downturn in the market, it would be wise to keep at least $300,000 in fixed income in the investor's portfolio.

However, this is a double-edged sword, since increasing fixed income also reduces the expected rate of return of the portfolio. Advisors must balance the need for return with the need for income/cash flow. While the stock market tends to go up over time and rewards investors with greater returns than bonds, stocks are more volatile than bonds. Different parts of the stock market return different premiums. The higher the premium, the higher the risk. When an advisor models market return they need to run models both retrospectively (using historical returns) and prospectively (using premium assumptions).

Educating clients who are not comfortable with investing in the stock market on the relationships and meaning of historical, and projected possible investment returns may be key to helping them decide how much risk they want to take in the proportion of fixed income and variable income assets in their portfolio to generate their desired or needed cash flow in retirement.

Depending on the client's situation and income requirements, an annuity, which is purchased from an insurance company, may be a partial solution to the client's need to have fixed income to offset downturns in the stock market. The sequence of returns problem does not disappear with an annuity but rather gets shifted to the sponsor of the annuity. Using highly-rated insurance carriers who can weather sustained rough equity (stock) markets should be a priority if going this route.

2. High-yield investments

In previous generations, people often met their cash flow requirements using either fixed income investments or high-yield stocks. The idea was that investors would not have to use their principal because the yield (dividends) on the stocks would be sufficient to meet their cash flow needs, no matter what happened in the bond or stock market. It's an alluring narrative that still holds sway among investors who try to use stocks or fixed income to make their budgets work.

The perils of using high-yield investments vary based upon which side of the ledger the investor is using. For the equity investor, higher yield stocks tend to be concentrated in certain industry sectors. For example, Real Estate Investment Trusts (REITs) and stocks weighted towards real estate often account for too much of the investments in portfolios that are designed to rely heavily on dividend income. The REITs and real estate stocks are overrepresented in the portfolio because they tend to have higher dividend yields (Carlson, 2019). Similarly, energy stocks and retail stocks also tend to be overrepresented in financial portfolios. This overrepresentation leads to *sector risk*, a particular kind of risk when stocks are concentrated in one industry or just a few industries. Should any of the overweighted industry sectors have a major downturn, it will push all the other assets in the portfolio that are affected by these sectors downward.

This may seemingly be just an inconvenience for the high-yield investor who has the stocks for their yield (not for their underlying value)—but there are consequences. Should the downturn in the stock market inconveniently coincide with a major health event or house repair, the investor may be forced to sell their stocks at an inconvenient time *and* will have to sell more shares than otherwise required. This leads to a slower portfolio recovery and fewer future dividends. Furthermore, when companies or sectors face stress, they may cut their dividends. When the market crashed in 2020, many global banks and energy companies cut their dividends (Ellyatt, 2021).

At the same time, there is a substantial tax benefit for high-yield stock dividends. To understand this benefit, it's necessary to first understand the ex-dividend date. The ex-dividend date is the cutoff date for paying the dividend to the stock owner. Any stock the investor bought before the ex-dividend date will receive that dividend, regardless of whether the investor still owns the stock or not when the dividend is actually paid. (Some investors either borrow or lend the stock, so they may not actually have the underlying stock but are still receiving its dividend.) If the investor has held the underlying stock for more than 60 days during the 121-day period that begins 60 days before the ex-dividend date, the dividend will be taxed under the long-term capital gains rate, which is a lower tax rate than ordinary income tax and lower than short-term capital gains tax (26 USC § 1(h)(11)). However, the downside taxwise is that the stock dividends are paid to the investor on a regimented schedule so that even if the investors don't need the cash, they still will receive it and owe the corresponding tax.

High-yield bonds have their own set of challenges. With the ten-year treasury yield (interest paid to the bond owner) continuing to be at historical lows (Macrotrends, 2021), finding high-yield bonds is difficult.

Two Main Drivers of Bond Yield

There are two primary drivers of bond yield—the **duration of the bond** and the **time to maturity**.

- **The duration of the bond** is a measure of how likely it is that the bond's interest rate will change during periods of rising interest rates. An increase in interest rates will bring down the value of the underlying bond because the bond pays lower interest than the increased interest rate, and the longer the bond maturity, the more significant the hit to the principal will be.
- **The bond maturity date** is when the bond principal (the amount the investor paid for the bond) must be repaid to the investor. The longer the **time to maturity**, the more the investor can gain in yield (interest payments).

The risk is that the longer it takes a bond to reach its maturity date, the higher its duration and, therefore, the higher the risk that market interest rates will change. A change in the market interest rate can lead to disastrous results for a bond investor. If a bond investor seeking a high yield buys a bond that matures well into the future, the probability of an interest rate hike in the market goes up, especially with today's yields. If this hike happens early in the life of the bond, the fair market value of the bond will drop precipitously because as mentioned earlier, the fixed interest rate the bond pays is lower than the new higher market interest rate. Like our high-yield stock investors who intend to live off dividends, the bond investors may think nothing of a drop in the bond's value, since they intend to live mainly off the bond interest anyway. On the other hand, like our stock investors, should a lump sum be needed during a market downturn, bond investors will lose their principal and future interest payments.

Effect of Inflation on High-Yield Bonds

In a similar vein, the specter of inflation is always lurking around the corner on a high-yield bond portfolio. Higher interest rates typically are the Federal Reserve's answer to higher rates of inflation. This means that a bond holder's retirement expenses may be going up while the value of the underlying bond positions are going down, and the interest payments remain nominally level while losing ground on a real dollar basis. Treasury Inflation Protected Security (TIPS) bonds can provide some shelter because the interest rate of the TIPS bond adjusts with the Consumer Price Index (CPI). However, there is no guarantee that the Fed will increase rates commensurately with the CPI. So, there may be a situation in which CPI outpaces, or is outpaced by, the Fed funds rate. This difference can cut both ways, so an investor needs to be careful about relying on TIPS.

Taxes on High-Yield Bonds

The tax situation with bonds is also far from ideal. Bond interest payments do not have a preferential treatment like capital gains or qualified stock dividends. Thus, bond interest income is taxed at ordinary tax rates, and like stock dividends, can be difficult to defer. Federal bonds offer shelter from state taxation. Municipal bonds are exempt from Federal tax and are not taxed in the state of issuance. However, their yields tend to be lower, and investors should do an after-tax calculation to compare them with non-municipal opportunities.

Addressing the Risks of High-Yield Investments: The Synthetic Dividend Model

A potential solution to the risks of high-yield investments is to use the *synthetic dividend approach*. With synthetic dividends, investors create their own dividend. They start by taking the investment yield (return) that a diversified portfolio would naturally give. For example, the Russell 3000 stock market index had a 1.26% yield as of July 31, 2021 (London Stock Exchange Group, 2021). A reasonable short-term bond portfolio that is *not* high yield would likely have a similar yield. If the investor who had a bond with a 1.26% yield needed a 5% per year distribution from their financial portfolio for income, which is a reasonable rate of withdrawal, there would be a 3.74% deficit. To fill that 3.74% gap between the amount of the bond interest payment and the amount of distribution the investor needs for income, the investor would use the growth in value in the rest of their diversified portfolio, (called capital appreciation) to supplement their cash requirement by using the dividend income from other diversified assets in the portfolio, and/or by selling some of these assets. (However, as discussed earlier, selling assets reduces the amount of principal in the investor's portfolio, which negatively affects the future growth and value of the portfolio and therefore the investment returns that provide retirement income.)

Benefits of the Synthetic Dividend Approach

There are several benefits to the synthetic dividend approach. *First*, investors can have a diversified portfolio and not worry about the failure of any sector or company. *Second*, they can time their cash flows to better meet their income needs and not unnecessarily incur income tax when the cash is not needed. *Third,* using capital appreciation, investors can select investments for more long-term capital gains. *Fourth*, using rebalancing of the portfolio, the investor can take the dividend gains from the stocks and reallocate these gains to the bonds in the portfolio, providing a buffer during a market downturn. (Rebalancing is the process of keeping the mix of assets in a portfolio at the investor's desired level of risk tolerance by buying or selling these assets at regularly scheduled times over the years based on whether assets are low, medium, or high risk.)

As discussed earlier, using stocks in a portfolio carries a fair amount of risk, and overexposure to the market could prove detrimental during market downturns. As such, the *synthetic dividend model is not a magic bullet*. A market correction means that any sale of stocks to supplement the portfolio's investment yield to generate more income will result in selling additional shares and could make financial recovery of the portfolio sluggish and jeopardize the length of time the investor could take distributions from their portfolio.

For any investment portfolio that is used for distribution of income, synthetic dividend or otherwise, having a bond component that is relatively stable and non-reactive to changes in the market is a must. Shorter-term, higher-quality bonds typically maintain stability during a market crisis and can provide stability for cash flows when needed. Using these types of bonds means giving up some yield, but when a distribution for income is required during volatile markets, bond holdings can provide the liquidity needed while the stock section of the portfolio recovers.

3. Illiquidity

Some assets can be easily and quickly sold or exchanged for cash for virtually the same financial value they have on the market. This is called liquidity. For example, a share of stock with a market value of $45 that can be sold for $40 or $45 is a liquid asset. Illiquidity is the opposite. Generally, it means that selling or exchanging an illiquid asset is difficult, time consuming, and with a significant financial loss.

However, illiquidity comes in a variety of forms. Annuities and real estate investments are two examples. The tradeoff for the investor is roughly the same no matter whether it's an annuity, real estate, or other form of investment: the investor gets more income for giving up a certain amount of control over the illiquid asset which the investor owns. Every investor has their own appetite for delegating investment decisions to a third party (like an insurance company that sells annuities) and willingness to give up control and flexibility with an asset

Annuities. The most popular of illiquid investments—and the one with the lowest barriers to entry—is the annuity. Annuities provide for stable cash flow and move the burden of stock and bond market volatility away from the investor and to an insurance company. Because they are legal contracts, annuities come in many different flavors and no two annuity contracts are the same. Some offer riders—facets of an annuity that can add some sort of benefit for an additional premium. Popular riders include death benefit, guaranteed income benefit, and long-term care.

Because annuities come in so many different varieties, it is very important for the investor and the financial advisor to read the details very carefully. Annuities can be quite expensive for an insurance company to offer, so many times the insurance company has a surrender penalty: if the annuity owner terminates the contract before a certain period, the owner pays a substantial fee (which reimburses the insurance company for its internal costs). Because annuities tend to be a commission-based product, the salespeople are not fiduciaries of the client, and so investors should shop around for the best fit by surveying multiple annuity providers. (A financial professional who is a fiduciary has a legal and ethical requirement to put the best interests of the client first over any financial gain the professional may realize from the client's investment.)

Prior to taking distributions from the annuity—and after the surrender penalty phase—annuities can be moved freely. Once the owner of the annuity, who is called the annuitant, starts receiving payments (when the annuitization period begins), annuities generally become illiquid. The stream of income the annuitant receives can be sold on the stock market, but often at distressed prices. A retiree who uses annuities to get better cash flow should weigh the cost of the illiquidity heavily.

Real Estate. Next, real estate is a popular illiquid investment. As we have seen in recent months, there has been yet another real estate boom in the United States. No matter where the property is located, prices are trending upward as is rent (CBS, 2021). This has led to many investors to dip their toes into the rental real estate market.

There are some great benefits to real estate. Using a triple net (NNN) property leads to the fewest headaches for investors because it means the tenant pays for repairs, taxes, and insurance, and the leasing contracts tend to be long and include escalation of rent clauses. Most novice landlords like residential properties because they are the easiest to understand, and when coupled with a management company, aren't too hard to handle.

However, those seeking cash flow from real property need to be careful. Real estate is easy to get into and hard to get out of. Due to real estate commissions and other expenses from selling, the asset must appreciate by a significant percentage to break even. There is also a time lag from desire to sell to getting the proceeds from sale. So, while not as illiquid as annuities in the annuitization phase, there are significant enough barriers to sale that an investor with a possible lump sum requirement would want to think twice.

How to Approach Illiquid Investments

Be sure to stringently evaluate whether illiquid investments are appropriate for a client's or one's financial needs and situation. While they are sometimes warranted, and even desirable, allocating too much of an investor's resources to an illiquid bucket can cause cash flow issues down the line. Combining liquid and illiquid investments in a portfolio helps ensure that the investor can ride out spikes in personal spending. Make sure that you as an investor have a sufficient cash buffer or have a healthy amount of marketable securities in your financial portfolio. Illiquid assets shouldn't dominate the amount of available funds one has to invest.

Investors who want and need cash flow either now or in the future have a lot to look out for. There are no silver bullets when it comes to producing cash flow, and every option must be evaluated with the risks and benefits in mind, all oriented to that of the client investor's perspective.

Clients may not be able to appreciate all the risks that may be familiar and easily tolerable to a financial professional. Often, getting a perspective from an outside counselor, such as a Certified Financial Planner, can give client investors clarity on the best set of solutions. Often, financial advisors have a single solution in mind, but mostly it's a mixture of solutions that present the best opportunities for the client. •CSA

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